The Term Funding Facility

Max Alston, Susan Black, Ben Jackman and Carl Schwartz[*]

Photo: Reserve Bank of Australia

Abstract

The Reserve Bank's Term Funding Facility (TFF) was announced in March as part of a monetary policy package to reduce funding costs across the economy and to support lending, especially to small and medium-sized businesses. Most of the initial allocations of the TFF were drawn upon by the time the first phase of the facility closed in September. In September, the Reserve Bank Board adjusted the TFF in response to economic conditions, expanding and extending the facility and in November it lowered the interest rate on new drawings. Drawdowns from the TFF have increased the Reserve Bank's balance sheet significantly and the facility has contributed to an easing in financial conditions. As a result of the Reserve Bank's policy measures, including the TFF, bank funding costs and lending rates are at historically low levels.

The TFF provides low-cost funding to support the Australian economy

On 19 March 2020, the Reserve Bank Board announced the Term Funding Facility (TFF) as part of a comprehensive policy package to support the Australian economy in response to the COVID-19 pandemic (RBA 2020a). The TFF provides low cost three-year funding for authorised deposit-taking institutions (ADIs) to support the supply of credit. It also provides an incentive for ADIs to increase their lending to businesses, especially small and medium-sized enterprises (SMEs).

All ADIs that extend credit are eligible to participate in the TFF. This includes more than 130 Australian banks, credit unions and building societies, as well as foreign bank branches and subsidiaries operating in Australia. Funding is available for all ADIs at a fixed interest rate, in line with the cash rate and the 3-year Australian Government bond yield targets, and secured with collateral to mitigate financial risk to the Reserve Bank.

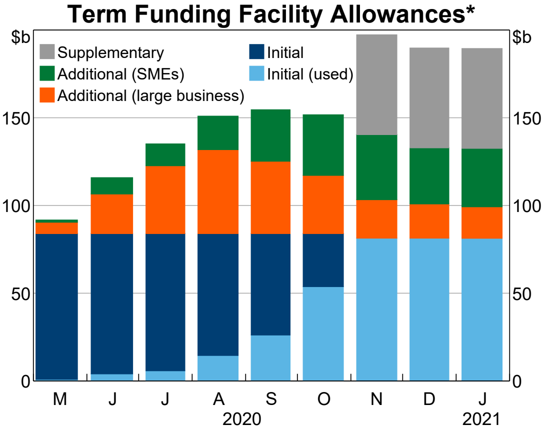
ADIs had access to two different funding allowances from early April: the initial allowance and the additional allowance. The initial allowance, set at 3 per cent of each ADI's total credit outstanding, was available to all ADIs until 30 September 2020. The additional allowance is available to ADIs that increase lending to businesses since around the start of the scheme. For every dollar of extra loans to large businesses, ADIs can access one additional dollar of funding, and for every dollar of extra loans to SMEs, ADIs can access five additional dollars of funding.[1]

Since the introduction of the TFF, the Reserve Bank Board has made adjustments in response to evolving economic conditions. At its September meeting, the Reserve Bank Board expanded and extended the TFF. ADIs were given access to additional low-cost funding through a supplementary allowance equal to 2 per cent of outstanding credit, available from 1 October 2020 until the end of June 2021. This decision ensured that ADIs without an additional allowance maintained access to the TFF after the initial allowance closed at the end September 2020. The drawdown period for the additional allowance was also extended from the end of March 2021 to the end of June 2021 (RBA 2020d). At its November meeting, the Reserve Bank Board reduced the interest rate on new TFF funding from 0.25 per cent to 0.1 per cent, in line with the reduction in other policy rates (RBA 2020e).

This article provides an overview of the objectives and design of the TFF and, with the drawdown window for the initial allowance closed, explores the take-up and effects of the scheme to date.

Graph 1

Term Funding Facility Allowances*



* Allowance amounts apply over a full month

Sources: APRA; RBA

The TFF has reduced interest rates and supported the availability of credit

Following the global financial crisis, central banks in a number of economies, including in the euro area, Japan and the United Kingdom, introduced longer-term lending operations. These schemes aimed to provide further stimulus when interest rates were near the effective lower bound and the supply of credit had contracted (RBA 2020b). These operations have generally been judged as effective (Potter and Smets 2019). Given the challenges arising from COVID-19, these central banks have renewed or retained existing schemes, and a number of others have launched new schemes, including central banks in India, Mexico, New Zealand, Singapore, Sweden and the United States.

The TFF in Australia has two main objectives: (i) to reinforce the benefits to the economy of very low policy rates by reducing funding costs of ADIs and, in turn, interest rates for borrowers; and (ii) to encourage ADIs to support businesses, particularly SMEs.

Two channels of transmission help to lower lending rates by lowering ADIs' marginal cost of new lending. Firstly, the TFF has a direct effect on funding costs, since it is cheaper than alternative forms of wholesale term funding. Secondly, the TFF has an indirect effect on funding costs, including by reducing ADI bond issuance, which places downward pressure on yields (Harimohan, McLeay and Young 2016).[2] This second channel benefits all ADIs, regardless of whether they draw from the TFF, and helps to lower costs more broadly for borrowers in wholesale markets.

The TFF aims to encourage lending to SMEs because they face particularly difficult economic conditions (Lowe 2020b). The additional allowance has markedly increased funding allowances for a number of ADIs that have relatively small initial and supplementary allowances (as they have relatively small loan books) but that have been able to increase business lending over the assessment window.

ADIs can count undrawn TFF allowances as liquid assets to meet their regulatory liquidity requirements, to the extent that they have eligible collateral that would not otherwise be counted (such as the debt of other ADIs). As a result, the TFF also immediately eased liquidity needs for some banks.

The TFF was designed to be sizeable, accessible, simple, attractive, and timely

To support the TFF's objectives, the facility was designed to be:

- sizeable – large enough to have some influence on funding conditions;
- accessible – available to all ADIs;
- simple – easy to operationalise and to understand;
- attractive – used by ADIs; and
- timely – available to ADIs quickly during a challenging period.

These design principles informed the setup, structure, and parameters of the TFF. In addition, the Reserve Bank Board noted that it retained the flexibility to modify any aspect of the scheme, which it has used on two occasions this year.

To ensure that the scheme was sizeable, at the outset the initial allowance was set at 3 per cent of an ADI's outstanding credit. With total credit just under $3 trillion, this meant that the available initial allowance was $84 billion, which amounted to over 4 per cent of GDP. The incentives included in the additional allowances added to the potential size of the scheme, although by design this ultimately depended on lending outcomes. The supplementary allowance provided greater confidence about continued access to low-cost funding given the potential for declines in business lending, which would lead to a reduction in existing additional allowances.

Granting access to all ADIs ensured low-cost funding for the prudentially regulated sector, which provides the bulk of financing to the Australian economy. The Australian Government created a complementary program of support for the non-bank financial sector, small lenders, and the securitisation market – the Structured Finance Support Fund – implemented by the Australian Office of Financial Management.[3]

The TFF was designed to be accessible and easy to operationalise for all ADIs by building on existing procedures for the RBA's open market operations. Accordingly, funds available under the TFF are lent in the form of repurchase agreements (repos), whereby the RBA provides funds to ADIs' exchange settlement (ES) accounts and receives highly rated securities from ADIs as collateral. Upon maturity or termination of the funding, the RBA receives ES funds from the ADI, with interest, and returns the collateral to the ADI. This operational choice also meant that the TFF could be operationalised through the Reserve Bank Information and Transfer System (RITS) regulations, rather than through separate contracts with each bank.

As with the RBA's other market operations, the collateral is the primary protection against counterparty risk for the Reserve Bank. Eligible collateral for this purpose was extended beyond the government and ADI securities typically used for open market operations to include the AAA rated tranches of self-securitisations – structured pools of assets such as residential mortgages created by ADIs (explained further below) – to facilitate large scale use (Cole and de Roure 2020).

In order to minimise the resource demands of ADIs associated with accessing the TFF, the data used to calculate ADIs' TFF allowances are taken, where available, from existing data collections. In most cases, ADIs have not needed to report new data to the RBA to access their allowance under the scheme, and additional reporting is only required for smaller entities that intend to access any additional allowance. This also means that the data provided by ADIs to calculate allowances are subject to existing quality controls and audit requirements.

The pricing for the TFF (initially 25 basis points and more recently reduced to 10 basis points) was designed to be attractive and cheaper than other sources of market funding to help lower ADIs' funding costs. In addition, to encourage participation, the incentives underlying the TFF additional allowance 'reward' desirable behaviour (such as increasing lending), rather than penalise less desirable outcomes (such as decreasing lending). This decision built on experience from schemes overseas, which, over time, have tended to make greater use of rewards rather than penalties (RBA 2020b).

Some overseas term funding schemes have used price incentives, rather than quantity incentives (typically where banks receive cheaper funding if they reach certain lending targets). The RBA's TFF does not involve price incentives; rather the price was chosen to align with the cash rate and 3-year yield targets and to fit with the principle of minimising uncertainty and operational complexity.

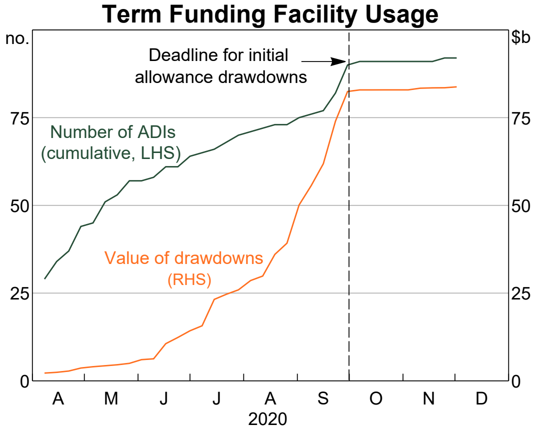
Keeping the design relatively simple and based on existing practices helped the Bank establish a scheme that ADIs could use in a short time frame. The scheme was open on 6 April, three weeks after being announced.

Banks accessed almost all of the initial allowance

Take-up of initial allowances was modest in the first few months of the scheme, notwithstanding a flurry of activity from some smaller banks in the first week (Graph 2). Policy actions, including the announcement of the TFF and the increased size and term of Bank market operations, had helped to significantly alleviate uncertainty about banks' funding positions that had arisen at the onset of the pandemic. ADIs' term funding needs in aggregate were low, reflecting their strong funding positions prior to the pandemic, strong growth in deposit funding and ADIs' expectations of modest growth in credit.

Graph 2

Term Funding Facility Usage



Source: RBA

Drawdowns picked up mid-year as some ADIs began to spread their drawdowns over the available funding window, partly to spread out the associated maturities in 2023. Take-up accelerated ahead of the deadline to draw down initial allowances at the end of September, with ADIs keen to lock in 3 year funding from the latter part of the drawdown period. Part of the drawing was to replace wholesale funding that would mature in future months. In aggregate, \$81 billion or 97 per cent of the \$84 billion TFF initial allowance was used (Graph 1). By number, around two-thirds of eligible ADIs accessed the TFF. Of the 89 ADIs that have accessed the TFF, most drew the vast bulk of their initial allowance.

The bulk of the value of drawdowns to date have used the AAA tranches of self-securitised residential mortgage-backed securities (RMBS) as collateral. ADIs can establish self-securitised RMBS using their existing mortgage assets. As a result, many ADIs do not need to purchase additional securities to use as collateral, and so do not need to take any additional credit or market risk. Self-securitised RMBS also have higher yields compared to other assets that can be used as collateral for the TFF, making RMBS more cost-effective than other forms of collateral.

However, not all ADIs have self-securitised loans. This may be because they do not lend in sufficient size to make it economic for them to incur the operational, legal and ratings costs required to set up a self-securitisation, or it may be difficult for them to achieve an AAA-rated tranche given the underlying loans. ADIs without self-securitisations have predominantly pledged corporate or bank bonds, with some pledging Australian and semi government bonds.

ADIs that did not draw down on their initial allowance mostly comprised of foreign banks and some smaller ADIs (Graph 3). Most of these ADIs do not have self-securitised assets, which made it more costly to access the scheme. These ADIs accounted for a very small share of total initial allowances, though they account for a larger share of additional allowances.

Additional allowances rose and fell alongside demand for credit by businesses

Each ADI also has access to an additional allowance if it has expanded lending to businesses since early 2020, providing an incentive for ADIs to extend credit.[4] The additional allowance available is updated each month following the receipt of the most recent data on large business and SME credit outstanding. Additional allowances rose strongly in the first few months following the commencement of the TFF (Graph 1). This reflected a sharp pick-up in large business lending, as businesses drew on revolving credit facilities for precautionary reasons in response to the COVID shock (Graph 4). More recently, however, additional allowances have declined from their August peak as large businesses have largely repaid these earlier drawings on credit lines.

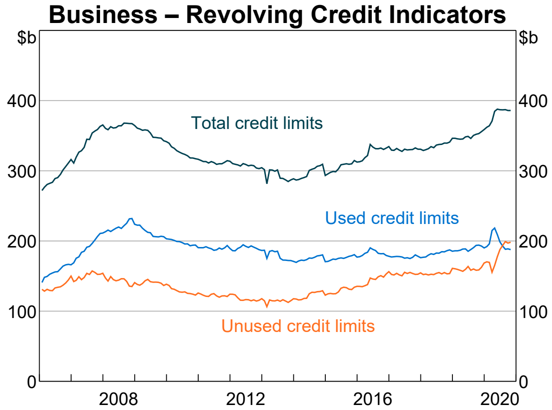
Aggregate lending to SMEs has remained around the same level over the past year or so (Graph 5). However, this aggregate hides the fact that SME lending by some ADIs has increased while SME lending by other ADIs has decreased over that period. By October, the bulk of additional allowances had been attributable to increases in SME lending since March.[5] However, demand for business credit overall has been soft, reflecting a reluctance by businesses to invest and take on additional debt in the current economic climate. Temporary initiatives, such as JobKeeper, have also alleviated businesses' need for funding by boosting cash flow for businesses (RBA 2020c).

The availability of credit to businesses has also tightened somewhat in response to the pandemic. Banks have indicated in liaison that much of this reflects the application of existing standards in a weak economic environment. Banks are also cautious about lending to sectors heavily exposed to the COVID shock (such as hospitality and accommodation) and to businesses that are new to that bank.

The major banks account for the bulk of TFF allowances in aggregate (Graph 6). However, foreign banks have the largest additional allowance in aggregate, due to their focus on business lending and somewhat stronger business credit growth since the start of the year.

Graph 4

Business – Revolving Credit Indicators

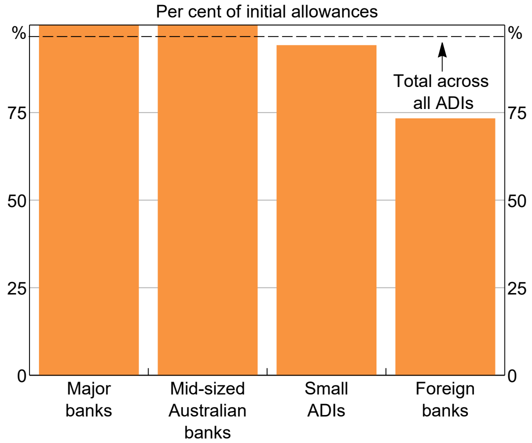


Sources: ABS; APRA; RBA

Graph 3

Term Funding Facility Initial Allowance Usage

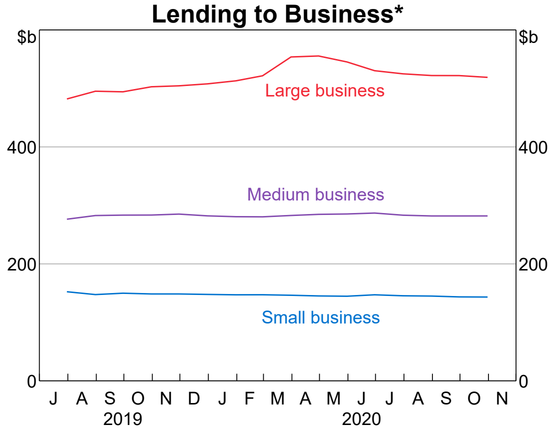
Per cent of initial allowances



Sources: APRA; RBA

Graph 5

Lending to Business*



* Data cover financial institutions with $2 billion or more in business credit

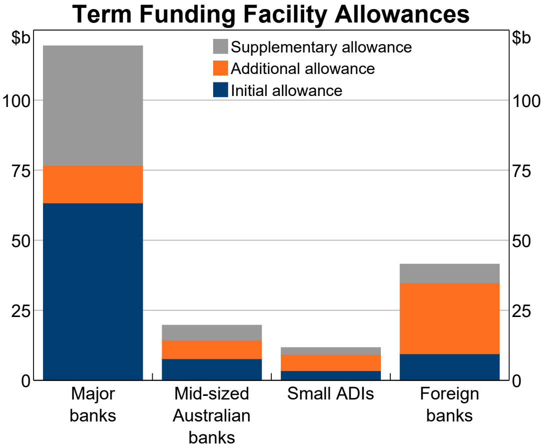
Sources: APRA; RBA

Use of the supplementary and additional allowances has been low to date

To date, usage of supplementary and additional allowances has been minimal, as banks remain well funded, use of the initial allowance has been larger than bond maturities over the same period, credit growth remains modest, and the deadline for drawing on these allowances is some time away (Graph 7). Similar to the initial allowance period, further TFF drawings are likely to be gradual for some time but increase towards the June 2021 deadline.

Graph 6

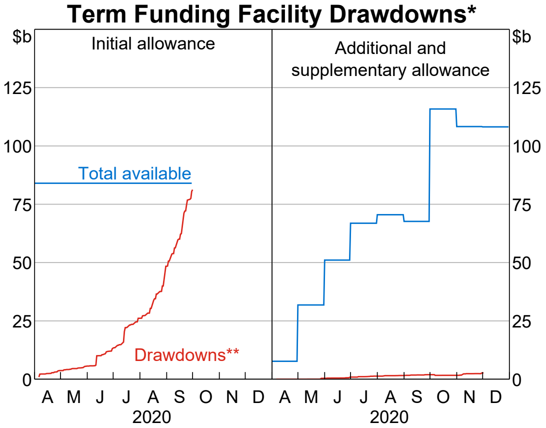
Term Funding Facility Allowances



Sources: APRA; RBA

Graph 7

Term Funding Facility Drawdowns*



* Until 30 September, repos were applied against initial allowance until fully drawn, then against additional allowance. From 1 October, repos applied against additional and supplementary allowances

** Includes all settled, contracted and pre-processed repos to date

Sources: APRA; RBA

The TFF is helping to keep funding costs and lending rates at historic lows

The interest rate paid on TFF drawdowns is lower than the marginal cost of market-based funding for the same term, directly lowering funding costs (Graph 8).[6] The availability of the TFF has also indirectly added to downward pressure on funding costs since March. This is because the availability of low-cost funds from the TFF has reduced the need to raise funds in other markets; in line with this, bond issuance by Australian banks has been subdued and bonds outstanding have declined noticeably since March (Graph 9). This lower supply of bank bonds has contributed to a decline in bank bond yields and yields more generally, as investors substitute towards other assets, such as corporate bonds. Like bank bonds, non-financial corporate bond spreads have narrowed since the policy package was introduced in March, in part because investors that would have previously purchased bank bonds have sought other assets. The TFF can also contribute to a reduction in a broader range of interest rates in the economy if banks use TFF funding to buy bonds (Kent 2020).

Although the TFF has reduced the incentive for some banks to issue bonds, the Australian bank bond market remains sizeable. The stock of bank bonds outstanding (excluding hybrids) is around $500 billion, with bonds issued in the domestic market accounting for roughly two-fifths of this. The TFF has temporarily displaced some of the market for Australian bank bonds issued both domestically and offshore and is likely to continue to do so, though the major banks have reported in liaison that they intend to ensure that the low issuance does not affect investor engagement. Meanwhile, there has been strong bond issuance by foreign-owned banks in Australia over the year to date. There has also been active issuance of RMBS by non ADIs.

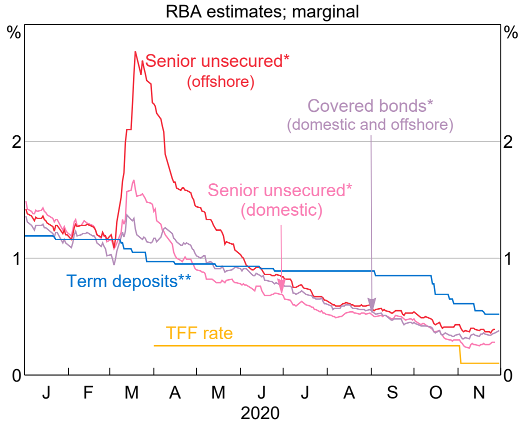
The reductions in funding costs from the TFF and from the other measures in the RBA's policy package have been passed through to business and household borrowers (Graph 10). A large portion of these reductions occurred immediately following the announcement of the TFF and other policy measures, before banks could draw on their allowances. Since the end of February, interest rates on variable-rate loans to large businesses have fallen by 80 basis points, while interest rates on variable-rate loans to small- and medium-sized businesses have declined by 70-75 basis points. Similarly, the average interest rate paid on outstanding variable-rate mortgages has declined by around 40 basis points and rates for new fixed-rate housing loans have declined by around 70 basis points since the end of February. The interest rates on new fixed-rate loans are now around 55-65 basis points below new variable interest rates and the proportion of loans funded at fixed interest rates has increased sharply since March (Graph 11). In response to the policy package announced on 3 November, including the reduction in the rate for new TFF drawings and the decline in the 3-year yield target to 10 basis points, banks further reduced lending rates on a range of housing and business loans, especially fixed-rate and small business loans.

As noted above, the TFF has been in place against an environment of soft demand for credit, and was introduced as part of a package of Reserve Bank policy measures designed to support the economy. As a result, it is hard to know how much the additional allowance incentives have been effective in supporting business credit growth. Some ADIs have noted in liaison that they have introduced initiatives to increase business lending to capitalise on the benefit from the additional allowance. While total lending to SMEs has been little changed since the start of the scheme, a range of ADIs have

Graph 8

Major Banks' 3-year Funding Costs

RBA estimates; marginal



* Recent estimates are uncertain due to low trading volumes and a lack of issuance

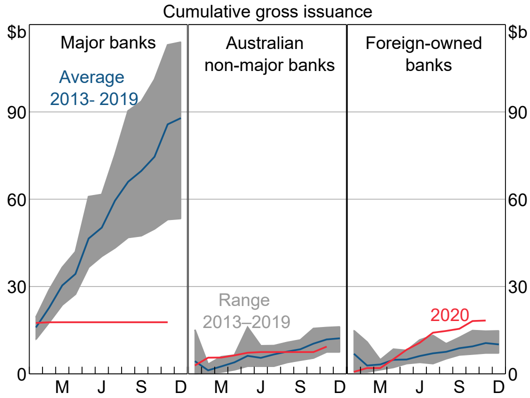
** Simple average of advertised rates on $10,000 deposits

Sources: Bloomberg; CANSTAR; RBA

Graph 9

Senior Bank Bond Issuance

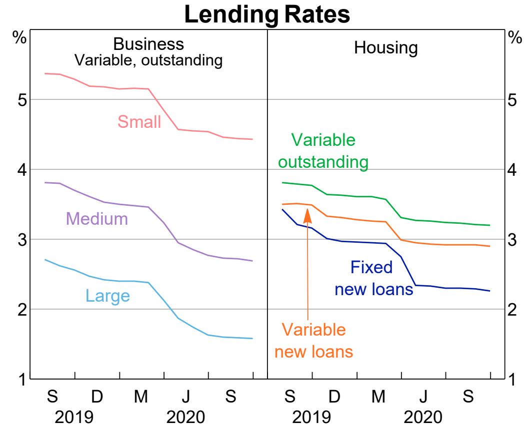
Cumulative gross issuance



Sources: Bloomberg; Private Placement Monitor; RBA

Graph 10

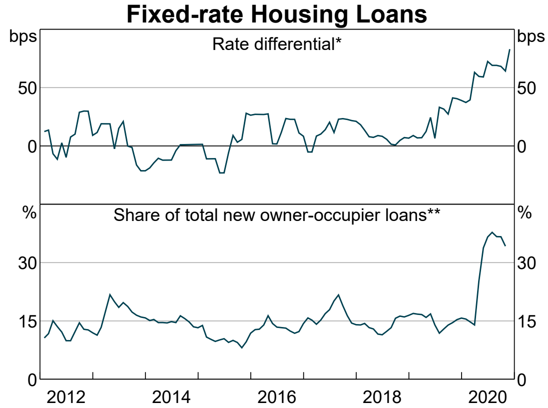
Lending Rates



Sources: APRA; RBA

Graph 11

Fixed-rate Housing Loans



* Rate differential between variable and fixed rate loans for owner-occupiers; major banks' package rates less advertised 3-year fixed rate to April 2009; thereafter, major banks' best advertised variable rate less advertised 3-year fixed rate

** Seasonally adjusted loan approvals data until September 2019; thereafter, loans funded in the month (non-seasonally adjusted)

Sources: APRA; CANSTAR; major banks' websites; RBA increased their lending to SMEs, benefitting from the option of drawing on their additional allowance.

Footnotes

[*] The authors are from Domestic Markets Department.

[1] Detail on how this allowance is calculated are available in the TFF Operational Notes, which include some Worked Examples.

[2] Harimohan, McLeay and Young (2016) conclude that the indirect impact on funding costs from the Bank of England's Funding for Lending Scheme was larger than the direct effect.

[3] See <https://www.aofm.gov.au/sfsf>

[4] As outlined above, for every dollar of extra loans to large businesses, ADIs can access one additional dollar of funding, and for every dollar of extra loans to SMEs, ADIs can access five additional dollars of funding. Detail on how this allowance is calculated is available in the TFF Operational Notes, which includes some Worked Examples.

[5] The additional allowances for SME lending can increase while the stock of aggregate SME lending remains unchanged; an ADI that expands SME lending will receive a positive additional allowance for this lending, while an ADI that contracts SME lending will receive zero allowance.

[6] Including for covered bonds, which are more directly comparable to secured TFF funding.

References

Cole D, and C de Roure (2020), 'Managing the Risks of Holding Self-securitisations as Collateral', RBA *Bulletin*, September, viewed 5 November 2020. Available at <https://www.rba.gov.au/publications/bulletin/2020/sep/managing-the-risks-of-holding-self-securitisations-as-collateral.html>.

Debelle G (2020), 'The Reserve Bank's Policy Actions and Balance Sheet', Speech to the Economic Society of Australia, Online, 30 June.

Harimohan R, M McLeay and G Young (2016), 'Pass-through of bank funding costs to lending and deposit rates: lessons from the financial crisis,' Bank of England Staff Working Paper No 590.

Kent C (2020), 'The Stance of Monetary Policy in a World of Numerous Tools', Speech to the IFR Australia DCM Roundtable Webinar, Online, 20 October.

Lowe, P (2020a), 'Responding to the Economic and Financial Impact of COVID-19', Speech at the Reserve Bank of Australia, Sydney, 19 March.

Lowe, P (2020b), 'Recovery from a Very Uneven Recession', Speech at Citi's 12th Annual Australia and New Zealand Investment Conference, Sydney, 15 October.

Potter S M and F Smets (2019), 'Unconventional monetary policy tools: a cross-country analysis', Bank of International Settlements Committee on the Global Financial System Papers No 63.

RBA (Reserve Bank of Australia) (2020a), 'Term Funding Facility to Support Lending to Australian Businesses', Media Release No 08, 19 March 2020.

RBA (2020b), 'Box A: Term Funding Schemes', *Statement on Monetary Policy*, May, pp 31–37.

RBA (2020c), 'Box B: Business failure risk in the COVID-19 pandemic', *Financial Stability Review*, October, pp 29–34.

RBA (2020d), 'Term Funding Facility Increase and Extension to Further Support the Australian Economy', Media Release No 20, 1 September.

RBA (2020e), 'Term Funding Facility – Reduction in Interest Rate to Further Support the Australian Economy', Media Release No 28, 3 November.